


# THE INTERNATIONAL DIMENSION OF REGULATORY REFORM: WITH APPLICATIONS TO EGYPT

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## Foreword

Domestic regulation is increasingly taking center stage in the theater of international economic relations. Bilateral, regional and multilateral agreements are expanding their coverage to issues such as domestic competition policy, environmental control and labor standards. These agreements are no longer limited to the elimination or reduction of trade barriers at borders, but cover a wide range of issues once considered the exclusive domain of national sovereignty.

This shift in orientation has acquired an undeniable importance. The nature of agreements on domestic regulatory policies can significantly modify the potential benefits to be gained from international trade, factor movements and the distribution of these benefits among nations. It is, therefore, essential to understand the economic and political motivations behind this shift in focus; to explore its implications for developed and developing countries; and to distinguish those policies which are better negotiated at the international level from those which are better addressed at the domestic or national level. In this publication Roger Noll does just that. His main conclusion is that trade liberalization and domestic regulatory reform are complementary.

The issue of internalizing regulatory reform stimulated extensive debate during Noll?s presentation at ECES. Participants discussed the implications for Egypt, wondering whether the country should leap ahead into worldwide markets or proceed at a slower but safer pace beginning with regional integration. The issue of national sovereignty over domestic regulatory policies vis-à-vis the WTO's ability to adjudicate disputes over these policies and levy sanctions was also raised. Finally, some participants questioned one nation's right to demand high standards of safety, environmental protection and quality from its trading partners. The discussion was lively and informative and left everyone with an abundance of food for thought. A summary of this discussion is provided in this edition of the Distinguished Lecture Series.

Ahmed Galal
Executive Director, ECES
October 1997

**تقــديم**

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أصبحت السياسات والتشريعات المحلية تحظى باهتمام متزايد فى مجال العلاقات الاقتصادية الدولية. ويرجع ما تقدم لاتساع مجال الاتفاقيات الثنائية والإقليمية ومتعددة الأطراف لتشمل قضايا محلية مثل سياسة المنافسة ومعايير المحافظة على البيئة، وقضايا العمالة. وهو ما يوضح أن هذه الاتفاقيات لم تعد مقصورة على إلغاء أو تخفيض الحواجز التجارية بل تخطت ذلك لتتضمن عدداً كبيراً من الموضوعات والتى كانت تعتبر، حتى وقت قريب، جزءاً من السيادة الوطنية لكل دولة.

وقد اكتسب هذا الاتجاه الحديث اهتماماً شديدا، نظراً لآثاره المتوقعة على حجم المكاسب المحتملة من كل من التجارة الدولية، وانتقال عوامل الإنتاج، وعلى نمط توزيع تلك المكاسب بين الدول المختلفة. وبناء عليه أصبح من الضرورى محاولة فهم الدوافع الاقتصادية والسياسية وراء هذا الاتجاه واستكشاف انعكاساته على الدول المتقدمة والدول النامية على حد سواء، وذلك بغرض التفرقة بين السياسات التى يجب التفاوض بشأنها على المستوى العالمى، وتلك التى يفضل أن تجرى معالجتها على المستوى المحلى أو القومى. وهذا هو الموضوع الذى ناقشه روجر نول فى هذه الدراسة. وقد خلص نول إلى نتيجة رئيسية مؤداها أن تحرير التجارة الخارجية وإصلاح السياسات والتشريعات هما أمران يكمل كل منهما الآخر.

وقد آثار عرض الموضوع بالمركز المصرى للدراسات الاقتصادية مناقشات عديدة، من بينها ما إذا كان يجب على مصر أن تمضى قدما لتقفز إلى الأسواق العالمية، أم أنه ينبغى أن تتقدم بخطوات تدريجية مبتدئة مسيرتها بالتكامل الاقليمى أولاً. وآثار الحاضرون أيضاً موضوع الخلاف الذى قد ينشأ من تعارض السيادة القومية على السياسات التنظيمية الوطنية وسلطة منظمة التجارة العالمية فى الحكم على المنازعات وفرض عقوبات بشأنها. وأخيراً تساءل البعض حول حق دولة ما فى أن تلزم شركائها فى التجارة بمستويات عالية من حماية البيئة ومن الجودة. وقد كانت المناقشات فى مجملها غنية ومفيدة بما أثارته من قضايا وموضوعات. ويتضمن هذا الإصدار من سلسلة المحاضرات المتميزة ملخصاً للورقة والمناقشات التى تلتها.

أحمد جلال

المدير التنفيذى للمركز المصرى للدراسات الاقتصادية

أكتوبر ١٩٩٧

## About the Speaker

# Roger G. Noll

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Roger Noll is Director of Stanford's Public Policy Program and the Program in Regulatory Policy at the Center for Economic Policy Research. A prolific writer and scholar with a wide range of interests, Dr. Noll has authored eight books and over 200 articles. His research interests include government regulation of business, public policies on research and development, the economic implications of political decision-making, and the economics of professional sports.

Noll received his doctorate in economics from Harvard University. Prior to taking a position at Stanford in 1984, he was Chairman of Humanities and Social Sciences at California Institute of Technology. He has served on the staff of the Brookings Institution and on the President's Council of Economic advisors, as well as several other advisory boards including those of the National Science Foundation, NASA and the Solar Energy Institute.

# PART I
# THE INTERNATIONAL DIMENSION OF REGULATORY REFORM WITH APPLICATIONS TO EGYPT[1]

## 1. Introduction

The consensus view among development economists is that the fastest and surest path to sustained economic growth is neoliberal reform. The key components of this package of policies are fiscal efficiency, monetary restraint, open participation in the international economy, and domestic regulatory reform. These policies are widely recognized as complementary. For example, recent studies demonstrate that the benefits from reductions in Egypt's formal trade barriers would be substantially higher if they were accompanied by tax reform[2] and by privatization and competition in port services.[3] In addition, several studies have examined the conditions under which sustained reform is politically feasible.[4] Some of these studies make the theoretical argument that appropriate bundling and sequencing of different reform policies can enhance the political sustainability of reform by identifying those harmed by one reform measure and adopting a companion reform that provides a compensating benefit to that group.[5]

For the most part, studies of the complementarities among neoliberal reform measures emphasize domestic economics and politics. This domestic focus provides extremely useful information about the connections between reform measures, but more extensive analyses are required to explain an important feature of almost all contemporary trade agreements: the presence of provisions about regulatory reform. For example, the completed and proposed agreements to implement the European Union's Mediterranean partnership program contain several provisions about administrative reforms, including harmonization of

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1 The author gratefully acknowledges the financial support for the work in preparing the essay from the Egyptian Center for Economic Studies, the Markle Foundation, and the Organization for Economic Cooperation and Development. Very useful comments and suggestions in preparing this essay were received from Ahmed Galal, Scott Jacobs, and Bernard Phillips. The author is solely responsible for the views expressed in this essay.

2 Denise Konan and Keith E. Maskus, "Joint Trade Liberalization and Tax Reform in a Small Open Economy: The Case of Egypt," unpublished manuscript, April 1997.

3 Nathan Associates Inc., "Egypt: Options for Increasing Market Competition in Maritime Port Services," Report for the Government of Egypt and USAID, June 1996.

4 For example, see Ahmed Galal, "Incentives for Economic Integration in the Middle East," Working Paper No. 5, Egyptian Center for Economic Studies, December 1996.

5 See Cesar Martinelli and Mariano Tommasi, "Sequencing of Economic Reforms in the Presence of Political Constraints," *Economics and Politics 9(2)* (July 1997): 115-131, and the references therein.

product standards, testing, and certification, and the application of competition policies to state-owned enterprises, many of which are domestic statutory monopolies.[6] Some have argued that these agreements would be more beneficial if they were more aggressive in granting rights of establishment, guaranteeing national treatment, and eliminating entry controls in infrastructural service industries such as electricity, financial services, telecommunications, and transportation.[7] The central role of regulatory policy in international trade agreements calls attention to an obvious fact: regulatory policies are not simply a matter of domestic policy. They have significant international repercussions, and so cause prospective trading partners to discuss regulation as part of trade policy.

In the popular debate over regulatory reform, foreign institutions (international organizations, other nations, or foreign businesses) play a major role, but they generally are perceived in a negative light. Foreigners may push for domestic policy changes, but their objectives frequently are portrayed as contrary to domestic interests. Accommodating these objectives is often portrayed as at best a loss of sovereignty and at worst an act bordering on treason.

The purpose of this essay is to examine the international dimension of the complementarity between trade liberalization and domestic regulatory reform. The ultimate objective is to prov ide a framework for understanding why regulatory reform quite legitimately has become a central issue in international trade negotiations and agreements, and to make some suggestions about how regulatory policy can be introduced into international agreements most productively for all trading partners.

## 2. The Evolution of Regulatory Reform

Regulatory reform is a very broad concept that has been a high profile political issue in several advanced industrialized nations since the 1960s. The domain of policies that constitute regulatory reform is extensive.[8]

One category of regulatory policies, called economic regulation, deals with controlling prices and entry. In countries with extensive government-owned businesses, reform of economic regulation begins with

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[6] Ahmed Galal and Bernard Hoekman, "Egypt and the Partnership Agreement with the EU: The Road to Maximum Benefits," Working Paper No. 9603, Egyptian Center for Economic Studies, 1996.

[7] For example, see Mahmoud Mohieldin, "The Egypt-EU Partnership and the Liberalization of Services," Working Paper No. 9, Egyptian Center for Economic Studies, February 1997.

[8] For a more complete discussion of these issues, see Roger G. Noll, "Internationalizing Regulatory Reform," in Pietro Nivola, *Comparative Disadvantage*, Washington: Brookings Institution, 1997.

privatization. For industries in which incumbent nationalized or intensively regulated private firms have enjoyed protected monopolies, another component of reform is to eliminate entry restrictions and to vigorously apply competition policy to incumbents to promote economically warranted entry. If historically protected incumbents can be expected to retain considerable market power for many years, despite the elimination of entry restrictions, reform will also involve adopting methods of price regulation that simultaneously increase the incentive of the firm to operate efficiently while reducing the incentive and the opportunity to pursue anticompetitive strategies against entrants. And, once entry has made these markets reasonably competitive, regulatory reform means deregulation.

A second broad category of regulation seeks to protect workers from hazardous work places and unfair labor practices, consumers from fraud and hazardous products, and the environment from pollution. In these cases regulatory reform consists of institutional changes that make regulations more efficient. One category of reform is to use performance rather than design standards in regulating hazardous products, working conditions, or environmental emissions. Another approach to reform is to make greater use of market mechanisms to induce firms to implement beneficial changes in production practices and product design. Examples include emissions taxes, tradable emissions permits, injury fines, and stringent labeling requirements, all of which rely to some extent on creating financial incentives for achieving regulatory policy objectives. Still another category of reform is efficiency-enhancing changes in regulatory procedures. Examples include requiring comprehensive economic impact analyses for new regulations, and granting standing in regulatory decision processes to competition policy agencies.

***Regulatory Reform and Free Trade***

The initial impetus to regulatory reform arose primarily from domestic economic concerns, and focused primarily on the appropriate boundary between the public and private sectors in the economy. A considerable amount of scholarly research in the 1950s and 1960s concluded that a great deal of economic regulation was inefficient and unnecessary, but that environmental regulation was too lax. The focus of this research and subsequent policy changes was purely the domestic effects of policy change.

The purely domestic orientation of the reform debate did not last long. An important feature of post-war economic policy is the movement toward free trade, especially among advanced industrialized nations. Initially, formal trade barriers throughout the world were large compared to the costs of domestic regulation. The estimates of the costs of regulation as a percentage of gross domestic product, while significant, rarely reach double digits, whereas tariff rates throughout the world at the end of World War II were typically in

the neighborhood of 25 to 50 percent, with quotas causing still higher implicit rates. With direct trade barriers of this magnitude, regulatory reform had minimal implications with respect to trade.

As trade barriers fell, regulation became a more significant factor in affecting the relative prices of exports, imports, and domestic production. As a result, regulatory policy became a matter of i nternational economic policy in three ways.

First, as emphasized in many economic studies, regulatory reform began to be perceived as a means by which a nation could capture greater benefits from trade liberalization. When tariffs and quotas no longer substantially limit the potential exports of a domestic industry, inefficiencies in domestic supply industries (including the heavily regulated infrastructural sectors) can determine the international competitiveness of a domestic industry with the potential for substantial exports. Likewise, for industries that rely on traded inputs, inefficiencies in regulations governing ports, domestic transportation, and standards for imported products can cause a domestic manufacturer to have production costs that are too high for profitable export.

Second, other forms of inefficient domestic regulation could cause an otherwise efficient firm to lose domestic market share to imports from nations with a better regulatory system. The key point is that a firm may have relatively low costs in transforming inputs to outputs, but face high costs in complying with inefficient regulations or heavily regulated domestic inputs. If the latter costs are high enough, they can offset the efficiency and locational advantages of the firm and cause it to lose sales to a less efficient foreign source of supply. The mechanisms that can lead to this outcome are similar to those which cause a loss of export markets.

Both of these two mechanisms for creating a connection between regulato ry and trade policies focus on the domestic consequences of the combination of free trade and inefficient regulation. The third mechanism by which regulatory reform became internationalized has foreign origins. In the preceding examples, inefficient regulation benefits foreign firms at the expense of domestic ones. However, regulation can have the opposite effect as well, creating an indirect trade barrier. For example, a highly inefficient domestic transportation system increases the advantage of close proximity between buyers and sellers, and so can have the effect of protecting an inefficient domestic firm from competition from more efficient foreign suppliers. Or, a unique design standard in work-place, product or environmental regulation can increa se the cost of entry by a foreign supplier of a product which is equally effective in pursuing the performance objectives of regulation but that uses a different design. In such cases, foreign suppliers may perceive

minimal gains in a trade agreement unless it includes changes in regulatory policy that eliminate the indirect trade barriers created by regulation.

***The Magnifying Effect of Regulatory Politics***

Regardless of the motivations behind inefficient regulation, bad regulations would have international consequences and hence create a linkage with trade policy. Nevertheless, the politics of policy formation creates opportunities for explicitly using the regulatory process for the purpose of erecting indirect trade barriers.

Except in the most authoritarian or theocratic regimes, policy formulation is likely to be distorted by the effects of non-uniformities in the organization of the interests at stake in a policy issue. In most countries, even nations with weak or nonexistent democratic institutions, governance is most accurately conceived as bargains among a coalition of groups with partially competing objectives and interests. The basic political institutions of a nation determine the precise way in which these policy bargains are made, but some fundamental principles, driven by the economics of political participation, will apply to some degree in all coalitional forms of government.[9]

An important factor influencing policy outcomes is derived from the theory of political organizations or interest groups. An effective political organization faces three types of direct costs: formation, participation, and opportunistic. The magnitude of these costs varies among groups, and may therefore influence the extent to which interests are mobilized to affect policies.

Formation costs are associated with getting members to join the organization and reach a common agreement about their policy objectives. In general, formation costs will be greater for larger groups and, holding size constant, for groups that have a greater diversity of interests that must be compromised before the group can establish a common policy. To some degree, formation costs need only be paid once. Hence, a group that is already organized for one purpose will face lower costs to extend its political activity into a second policy issue, for which it is sufficiently homogeneous to achieve a common objective.

Participation costs are associated with influencing the policy process by gathering information, lobbying public officials, and engaging in formal legal and policy-making processes. Participation is a form of public

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[9] The classic foundations of the economic approach to politics were set forth in Anthony Downs, *An Economic Theory of Democracy*, New York: Basic Books, 1957, and Mancur Olson, *The Logic of Collective Action*, Cambridge, Mass.: Harvard University Press, 1965. For a more complete summary of the application of these principles to policy formation, see Roger G. Noll, "Economic Perspectives on the Politics of Regulation," in Richard Schmalensee and Robert Willig, *Handbook of Industrial Organization*, New York: North Holland Publishers, 1989.

good for all members of the group in that greater and more effective participation to achieve the group's common ends must be provided uniformly to all members. Hence, participation costs per group member, given the intensity or quality of participation, decline as the group becomes larger.

Finally, opportunistic costs refer to the consequences of self-interested behavior by group members that undermines the group. One example is free-riding by not contributing to the success of the group. Because political organizations pursue common objectives, their policy effect is also a form of public good for all group members. Hence, political organizations face the classic problem of free-riding: a group member has an incentive not to bear a fair share of the group's cost because the benefits of group action will be experienced regardless of whether that member contributes. Of course, the incentive to free-ride depends on the inconsequentiality of the support of a single member, which in turn is more likely to be true as a group becomes larger.

Another form of opportunistic cost can arise when a member of a group is given authority to act for the group as a whole. If group members agree on the preferred general direction of policy change, but differ in the details, those selected to act for the group may have the opportunity to press for policies that correspond to their personal preferences rather than for the group consensus agreement. For example, in a coalition government, a minister may implement a policy that strays from the coalitional agreement. Moreover, this policy may be irreversible. In a diverse coalition, some members will prefer the policy as implemented to the original policy agreement. They may have sufficient support from groups that are not a part of the governing coalition. In this position, they can effectively block an attempt to restore the original agreement or threaten to bring down a government if the implemented policy is substantially altered.[10] The likely magnitude of differences between implemented and agreed policies is greater if groups are more heterogeneous.

The economic theory of organization posits that groups will become mobilized politically if the benefits of organization exceed the costs for both the group and the individual members. The nature of organizational costs favors homogeneous groups that are already organized for another purpose and, depending on the magnitude of the fixed cost of participation, smaller groups that are less susceptible to free-riding. In other words, if a group faces a high average cost of organization, it must also expect a large

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[10] For further elaboration of this argument, with applications to U.S. environmental policy, see Mathew D. McCubbins, Roger G. Noll, and Barry R. Weingast, "Structure and Process, Politics and Policy: Administrative Arrangements and the Political Control of Agencies," *Virginia Law Review 75* (1989): 431-482.

per capita benefit from becoming organized. Thus large, heterogeneous groups with a very large aggregate interest but a very small per capita interest will tend not to be mobilized politically. As a result, special interests -- small groups of people who share an intense, if narrow, interest -- will be better represented in policy processes that involve their common interest. Moreover, the extent to which policy will be responsive to these well-organized interests will depend on how policy issues are framed and decided. Specifically, if policy making is fragmented into a long sequence of independently made, highly specialized decisions, each policy decision is likely to be heavily influenced by the bias in effective political organization. The reason is that as issues become narrower and more specialized, fewer organizations are likely to have become mobilized to participate in the process.

These principles of political organization and policy responsiveness have transparent application to both trade and regulation. In the case of trade policy, outcomes can be expected to depend on precisely how trade issues are framed.[11] Prior to the era of trade liberalization, trade policy was decided primarily on the basis of domestic statutes in which tariffs and quotas were considered on a commodity by commodity basis. In such a process, a well-organized industrial interest is likely to participate when trade openness is discussed with respect to its industry, and perhaps when policy concerning an important input is on the table, but not to participate otherwise. This type of process biases overall trade policy in the direction of protectionism, especially for consumer goods and for intermediate goods that are not a significant component of total costs for any industry. In the era of freer trade, the policy process has been much different, focusing instead on broad negotiations, frequently multilateral in character, that seek across the board reductions in trade barriers and which are then presented as a complete package, to be adopted or rejected as a whole, to the prospective partners to the agreement. In this process, the particularistic special interests of one country are balanced against those of another. Within each nation, elevating the policy debate to the level of trade policy in general, rather than to a sequence of specific tariffs and quotas, undermines the influence of each special interest to obtain special protection.

In one sense, the change in the methods of making trade policy represents a "loss of sovereignty" in a very limited sense: one key to making free trade possible was to restructure the policy-making process to reduce the influence of domestic special interests, partly by enfranchising foreign interests in the policy process. Yet in a broader sense, this change is not a loss of sovereignty, but a means for overcoming a

[11] For a more thorough discussion of the dependence of trade outcomes on the way trade policy is formulated, see Judith Goldstein, "International Institutions and Domestic Politics," Center for Economic Policy Research, Stanford University, September 1996.

systematic bias in domestic policy formation. In this way foreigners have economic interests that harmonize with underrepresented domestic groups -- namely, large groups with a small per capita stake (but large total stake) in the efficiency benefits of freer trade.

A parallel argument applies to regulatory policy making. For the most part, regulatory policy is implemented through a very large number of independently made, narrow decisions. Typically, sectoral ministries are assigned responsibility for a few industries, and these ministries are further divided into industry-specific bureaus and, in many cases, state-owned monopolies. This mechanism stacks the deck in favor of the supply side of each regulated industry, for rarely will any other economic interest have a large enough stake in each regulatory decision to attempt to influence it. As a result, regulatory policy has a systematic tendency to favor regulated interests: to protect them from competition, to allow firms to charge super-competitive prices and to pay super-competitive wages, and to insulate them from technological changes that are socially beneficial but that would harm some participants in the regulated industry.

A slightly more general form of the same problem arises when one interest that is antagonistic to the regulated industry is represented, but the rest are not. For example, one important customer group may have a large stake in the regulated industry, and so participate in its regulatory process. The result is then likely to be cross-subsidization: the organized customer group will enjoy prices that are below cost, while other customers will be forced to pay higher prices to offset the losses incurred in serving the favored group. Another example arises in the context of some product, work-place, and environmental regulation, in which ardent supporters of stringent regulation and the representatives of the regulated industry are represented, but the consumers of the regulated product are not. The result from this environment is regulations with more costs than benefits, but that reduce competition among producers. This is achieved by applying even more stringent standards on new products and firms than those applied to established businesses, and by using regulation to assist producers in forming a cartel, for example by limiting their aggregate production.

Juxtaposing the account of trade and regulatory policy making provides an additional important insight. The discussion of trade policy is not based on the notion that free trade arose because its economic attractiveness somehow became substantially stronger -- although such a change may well have occurred, at least in the perceptions of citizens and relevant political actors. It instead focused on how changes in the trade policy-making process produce different outcomes. The protectionist desires of specific industrial interests did not necessarily vanish, but a new process reduced their influence.

If this account is even partly true, regulatory policy as practiced -- with its excessive responsiveness to narrow special interests -- is likely to reflect the same protectionist influences that motivated trade policy before the movement towards free trade. In particular, if firms see regulation as a means to protect themselves from international competition, they are likely to favor regulations that create indirect trade barriers. The typical regulatory process has no natural mechanism to prevent this outcome. Hence, if a regulation creates an indirect trade barrier, the regulatory process is likely to view this effect as a benefit, not a cost. In any case, regulation will probably even sacrifice the putative purpose of regulation which is to achieve greater protection. This feature of regulation boosts the impulse to incorporate regulatory policy into international agreements. Existing mechanisms for negotiating trade agreements were specifically designed to neutralize the very special interest biases that are likely to influence specific regulations.

## 3. Illustrations and Examples

The notion that domestic regulations frequently are adopted explicitly for the purpose of creating indirect trade barriers may seem hopelessly cynical, but unfortunately it is supported by a large number of examples.

### *Bicycle Safety*

The United States Consumer Product Safety Commission was created in 1972, and among its first actions was to adopt safety standards for bicycle brakes. The basis for writing such a standard was entirely rational in that many deaths and injuries occurred while riding bicycles, and an important cause of these accidents was brake failure. By statute, the Commission was required to seek proposals from industry on how to attack this problem, and so the trade association for American bicycle manufacturers submitted elaborate design standards for bicycle brakes. Focusing solely on the effectiveness of the proposed braking system, the Commission adopted the standard. Shortly thereafter, the Commission discovered that the standards had been designed not just to make brakes more effective, but to make foreign bicycles illegal. The standards had been written with very precise measurements and tolerances expressed in the English system (inches), whereas foreign manufacturers built bicycle components on the basis of the metric system. Although most European bicycles were at least as safe as American models, the specific form of the regulation prevented them from being sold in the United States. Rewriting the regulations to undo the damage took several months, during which time the American manufacturers enjoyed the benefits of a bicycle scarcity.

### *Cassis de Dijon*

*Cassis de Dijon* is an alcoholic beverage made from currents in the Burgundy region of France. The creation of the European Common Market eliminated direct trade barriers to cross -border sales of alcoholic beverages. These were extensive barriers since most members previously so ught to protect their own beer, wine, and hard liquor industries. In addition, alcoholic beverages are relatively intensely regulated everywhere. Among other things, regulations frequently include labeling requirements about origin and content. Germany, in particular, had content and labeling restrictions regarding liqueurs which permitted the sale of German beverages (such as flavored Schnapps) but not French. The Germans steadfastly defended these regulations as protecting consumers, but the Commissio n of Europe and the European Court both ruled that they had no rational basis because there were only minor differences in the alcoholic content of the products.

***German Bottles***

Another series of European cases arose from the recycling regulations of various member countries, the most interesting of which dealt with the German requirements. The rise of environmentalism throughout the advanced industrialized world led virtually all of these countries to adopt rules that encouraged recycling. In Germany, the regulations required each manufacturer of a bottled beverage sold in Germany to develop a recycling network for its bottles. The manufacturer could not delegate this responsib ility to others, but had to establish centers for collecting bottles and then arranging for their reuse. Of course, German manufacturers typically enjoyed much larger sales in Germany, and so could capture scale economies in collecting bottles. But firms with small sales, most of which were foreign, were effectively excluded from the market because of the high cost per bottle of establishing a recycling system in Germany. Again, Germany defended this policy on the basis of environmental protection and con servation, but the Court of Europe decided that the prohibition against pooled or contract recycling systems had no rationale other than to protect German industry against foreign competition.

***Canadian Red Raspberries***

A provision of the Canadian-American Free Trade Agreement was similar to the European Common Market provision prohibiting the use of regulation as an indirect trade barrier. This provision was enforced by an entity called the Bilateral Commission, which was subsequently replaced by the Trilat eral Commission when the two countries admitted Mexico to their free trade region under the North American Free Trade Agreement. Among the first cases decided by the Bilateral Commission was a complaint by Canadian

farmers that their raspberries had been excluded from the US market. The source of the complaint was an American regulation requiring that raspberries satisfy a color standard to be sold as fresh products at retail. Canadian raspberries are not as red as the American product. The United States defended the regulation as a consumer protection measure, presumably protecting against the consumption of insufficiently colorful berries. The arguments against the US position were that, first, there was no correlation between color and food value, taste, or healthfulness, and second, the color of a raspberry was obvious in the packaging at the point of sale, so customers who preferred redder raspberries could easily select an American variety. The Bilateral Commission agreed, finding that the sole purpose of this regulation was to protect American raspberries against foreign competition.

***Venezuelan Gasoline***

The Uruguay Round of the General Agreement on Trade and Tariffs (GATT) contained new provisions against indirect regulatory trade barriers, and created the new World Trade Organization (WTO) to enforce this agreement. The very first WTO case involved US regulations concerning the chemical composition of gasoline for motor vehicles. The Clean Air Act of 1990 mandated the use of so-called reformulated gasoline -- a new version of motor fuel that led to substantially lower exhaust emissions. But the new regulations did not simply establish a common standard for gasoline. Instead, they required that each refiner improve its gasoline by the same amount. The desired effect of this regulation was to prevent imposing extremely large improvements (and, therefore, atypically large costs) on certain small, independent refiners that produced especially dirty fuels. Of course, the reformulated gasoline rules were to be applied to imported fuel as well, including gasoline manufactured in Venezuela, which has a significant market share in the eastern United States. But rather than impose the same improvement rule on imports, the United States insisted that Venezuelan fuel achieve the average emission reduction for all US gasoline. Because Venezuelan gasoline was dirtier than the average among American refiners, the effect of this rule was to impose greater improvement and higher costs on Venezuelan refineries than were imposed on U.S. producers. The WTO ruled that this violated the GATT by not according national treatment to Venezuelan products.

Each of these five cases illustrates the arguments about the protectionist bias in regulation. Each also illustrates an important aspect of the loss of sovereignty argument against internationalizing regulatory reform. In every case, regulation produced policies that conflicted with the trade policies in the same nation. In essence, in each country regulatory policy makers were at odds with trade policy makers within the same

government, reflecting the differences in how these two policies are formulated. These cases do not reflect any fundamental conflict among policy objectives, for in each case the regulation in question protected a domestic industry from foreign competition without making any contribution at all to the stated objective of the regulatory policy. Instead, regulators, whether intentionally or inadvertently, wrote rules that trumped the agreements reached by their colleagues in trade treaties.

## 4. Indirect Trade Barriers as Byproducts of Bad Regulation

The preceding examples represent extreme cases in which no conflict of values arises and so a distorting regulation is blatantly protectionist. In other cases regulation may create an indirect trade barrier, but more as a byproduct of an inefficient or idiosyncratic policy choice.

In some cases regulations that appear to a trading partner as blatantly protectionist may actually reflect value conflicts between nations. Some examples are banning all British beef by other European Union countries in the wake of the "Mad Cow Disease" epidemic, banning American beef in Europe because US ranchers use growth hormones, and banning tuna in the United States that is imported from countries that do not use "dolphin safe" fishing methods. In each case, the principles of national treatment and mutual recognition come into conflict with regulations that are specifically aimed at a safety objective that is controversial. In these cases, the heart of the issue was whether a nation violates its trade agreements by pursuing policies that are idiosyncratic (such as the desire to avoid killing a species that is not endangered, as is the case of dolphins) or which protect against a small or nonexistent risk (that all British beef risks causing harm to consumers, and that beef raised on growth hormones imposes risks on consumers).

Another category of regulatory trade barriers is simply economically costly regulations that reflect a rationalizable purpose but impose costs on both the domestic economy and international trade. For example, a state-owned enterprise (SOE) operating with a statutory monopoly franchise is likely to price inefficiently, to undersupply the market in both quantity and quality, to use politicized non-price methods to allocate supply, and to operate with soft budget constraints and substantial public subsidies.[12] An inefficient SOE distorts trade in three ways.

First, SOEs can prevent disfavored domestic user industries from being able to compete internationally by providing poor, highly priced inputs, and can enable favored user industries that are otherwise inefficient

[12] See Ahmed Galal, Leroy Jones, Pankaj Tandon, and Ingo Vogelsang, *Welfare Consequences of Selling Public Enterprises*, New York: Oxford University Press, 1994, and World Bank, *Bureaucrats in Business: The Economics and Politics of Government Ownership*, New York: Oxford University Press, 1995.

to be successful internationally by cross-subsidizing their inputs. However, in the latter case the favored industry may experience a Pyrrhic victory, for importing nations may detect the subsidy and impose countervailing duties.

Second, SOEs can inhibit efficient international vertical integration that involves importing unfinished products and inputs for domestic industries. Coordination of vertically integrated production requires efficient communications and transportation services, and compatible standards among international and domestic inputs to the back end of the production process. In each case, a domestic SOE may be sufficiently inefficient in production and idiosyncratic in product design that its products can not be efficiently combined with imported inputs.

Third, the entry controls and even prohibitions that protect SOEs obviously inhibit entry through foreign direct investment. In addition, strict interpretation of statutes that prevent entry can prevent integration by either foreign firms or domestic importers into activities that substitute for SOEs privately within the firm. For example, statutory monopolies in telecommunications frequently are interpreted to prohibit private networks as well as public communications services.

Whereas these policies distort trade, in most cases the trade policy aspect of the policy is more a byproduct of a larger distortion than a consciously designed indirect trade barrier. Except in the case of blatant subsidies, these policies are not likely to be vulnerable to attack through international trade requirements regarding national treatment because the relevant regulations treat national firms equally unfairly and inefficiently.

**5. Applications to Egypt**

Only recently has Egypt started down the path of trade liberalization. Direct trade barriers (tariffs, quotas, outright exclusions) were very high during the long era of state-led development. Although trade barriers are now being reduced, they remain high compared to either advanced industrialized nations or the rapidly growing developing economies in Asia and Latin America.[13] Consequently, in the vast majority of cases, trade-distorting domestic regulations in Egypt should not be interpreted as motivated primarily by the desire to erect an indirect trade barrier.[14] In a society that already has high direct trade barriers, additional indirect

[13] For more details about Egyptian trade policy, see Jeffrey Sachs, "Achieving Rapid Growth: The Road Ahead for Egypt," Distinguished Lecture Series 3, Egyptian Center for Economic Studies, 1996.

[14] Defenders of existing policies sometimes raise the specter of foreign influence as a threat should policy by relaxed, as, for example, with respect to the present system of nationalized monopoly ports in Egypt. (See "Deregulation of the Egyptian Economy: Options

trade barriers are not necessary. Of course, this situation is likely to change as direct trade barriers fall, for the same reasons that in advanced industrialized countries regulation was more prone to be used for protectionist purposes after free trade agreements were implemented. But for the most part, the trade-distorting regulations now in place in Egypt are simply holdovers from an era in which market processes were in disfavor as a means for achieving economic development. This section provides a few examples of international business opportunities that are inhibited by existing policies.

***Agricultural products***

Until the 1990s, Egypt pursued a form of interventionist agricultural policy that is common among developing countries, especially in Africa.[15] The effect, and likely purpose, of these policies was to subsidize consumption, especially in urban centers. The critical features of this policy were: price ceilings on prices paid to farmers; direct controls of cropping decisions through area crop controls and marketing quotas; a government monopoly in distribution of most agricultural products in which farmers were required to sell all or most output exclusively through a government marketing agency; and subsidized inputs such as water, seeds, fertilizer, and credit, often provided through SOEs with political control over the allocation of these inputs.[16]

These policies had substantial trade distorting effects. One consequence was that the regulatory system contributed to domestic shortages in agricultural products that gave rise to increased import demand. The general policy of suppressing prices, controlling cropping decisions, and allocating inputs substantially weakened the incentive for efficiency in production. Moreover, taxing agriculture to subsidize cities encouraged rural-urban migration, thereby further reducing agricultural output. In addition, the relative outputs of different agricultural products distorted production within the agricultural sector, causing specific shortages in crops that were implicitly disfavored by the regulatory system.

Another consequence was that the system sacrificed opportunities for profitable exports that might have been present for some commodities. The state monopoly marketing system understandably was primarily oriented toward serving domestic consumers, rather than maximizing the income derived from agriculture

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for Increasing Egypt's Competitiveness in Maritime Port Services," Report on Conference Proceedings, Ministry of Economy and International Cooperation, October 1996.) Because port regulations go far beyond preventing entry by foreigners, protectionism is not a plausible explanation for port policies.

[15] For an excellent analysis of the political causes and economic consequences of these policies throughout Africa, see Robert Bates, *Markets and States in Tropical Africa*, Berkeley: University of California Press, 1981.

[16] For more details, see Ronald I. McKinnon, "Lessons on Sequencing Financial Reforms in Agriculture: A Perspective on Egypt," Working Paper, Department of Economics, Stanford University, July 1995.

by promoting exports. But probably of greater significance was that entrepreneurial farmers and marketers who might want to pursue profitable international market opportunities were precluded from doing so by state-mandated acreage controls, marketing quotas, and price ceilings.

Although the regulatory system for agriculture is being reformed, even complete reform still would leave agriculture subject to other distorting policies. Agriculture is strongly influenced by domestic transportation regulation because agricultural products frequently have relatively low value per unit weight (and hence high transportation costs as a fraction of delivered price). With respect to trade in agricultural products, the most significant transportation policy is the operation of the port services system.

Egypt has a natural advantage in some agricultural products. Its all-year growing climate and short distance to Europe create an attractive market for off-season fruits and vegetables. Moreover, its propinquity to oil-rich but soil-poor Middle Eastern nations provides still another potentially attractive market. But many of the products that might be sold in these regions are highly perishable, so that transshipment services that are subject to long delays and rough handling inhibit export, regardless of the relative efficiency of Egyptian agriculture. Although port charges in Egypt are high, the low quality of service is probably an even more important barrier to trade in perishable products.

Egyptian agriculture faces still another trade barrier in the form of the agricultural policies of the European Union,[17] which is extremely protective of European agriculture. Agricultural imports are generally permitted if they do not compete with European products, such as off-season imports from tropical or Southern Hemisphere countries or crops that are not grown extensively in Europe. And even in these cases, import quotas are common. Consequently, the agreements that the European Union has offered to Mediterranean countries do not permit substantial expansion of agricultural exports to Europe.

EU agricultural policies have a perverse effect on the domestic politics of regulatory policy in Egypt. Because the European Union inhibits exports of agricultural products from Egypt, it causes farmers to have a lower stake in regulatory reform in the port and transportation sector, which in turn causes the domestic political pressure for reform in these sectors to be less than would be the case if the EU markets were opened. This example illustrates another linkage between trade and regulatory policy. Should Egypt successfully negotiate a more liberal EU policy regarding agricultural products, the political feasibility of

[17] For more details, see Mohieldin, op. cit.

reforming the port system would increase because an important economic interest would perceive a greater stake in this policy.

***Consumer goods***

Egypt is well positioned to enjoy substantial international success in several consumer products. First, the extremely high quality of Egyptian long-staple and very-long-staple cotton makes Egypt a natural location for cotton textile and clothing manufacturing. Many developing countries, notably India and Mexico, have successful textile and clothing manufacturing, so that further development of these industries in Egypt is a realistic opportunity. Second, the rich, unique culture and history of Egypt provide an opportunity for creating a niche in luxury consumer goods such as art, jewelry, pottery, and glassware.[18] As with textiles, many developing countries in Asia and Latin America have created booming luxury goods industries that are derived from their unique cultural heritage.

Luxury consumer goods can be marketed in foreign countries through two channels: direct sales to consumers through direct mail catalogs and tele-shopping, and wholesale distribution to retailers. In both cases, successful marketing is greatly facilitated by inexpensive, high-quality communications and transportation.

In advanced industrialized nations, direct marketing to consumers is a rapidly growing industry, especially in the United States. In the 1980s, catalog sales grew dramatically, and in the 1990s, usage of the Internet to market consumer products has skyrocketed. These marketing methods are attractive because they avoid the entire wholesale and distribution system, allowing manufacturers to charge full retail prices through direct sales rather than to price in a manner that permits adequate mark-ups to a sequence of intermediaries. The unexploited opportunity here is for Egyptian companies, either manufacturers or resellers such as the shop at the National Museum in Cairo, to distribute catalogs or, more plausibly, to establish a web-site for the purpose of marketing luxury goods directly to foreign consumers.

Unfortunately, at each stage of the direct marketing process, an Egyptian company is likely to face significant indirect trade barriers.[19] First, a web-site will work as a means of marketing products only if

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[18] Egypt's major tourist attractions are remarkably devoid of consumer products in comparison to museums and other tourism sites elsewhere in the world. The underdeveloped state of these industries, as revealed in the spartan offerings at the shops in and around the National Museum, the various temples and other ancient structures in the upper Nile region, and the tombs at Luxor, is something of a puzzle. In any case, these products may represent an attractive business opportunity, especially if producers can achieve greater scale by selling these products in foreign countries as well as to visiting tourists.

[19] For a more thorough treatment of these barriers, see Noll, "Internationalizing Regulatory Reform," op. cit.

high-quality, low-cost telecommunications connections are available. Catalog sales require some means of placing orders. International mail delivery is notoriously slow, and in Egypt eventual delivery is also uncertain. Hence substantial catalog sales are likely to be feasible only if customers can place orders by telephone, facsimile, or electronic mail. Hence the first barrier to Internet marketing from Egypt is the relative inefficiency of the Egyptian telephone system.

Once the order is placed, a second requirement is to arrange for international transactions. For an international direct marketer, transactions require the intermediation of a bank to accept deposits in foreign currencies and undertake currency exchange. Indeed, direct market retailers are likely to require additional banking services, notably short-term loans to build inventories prior to sale. Hence inefficient banking, as reflected in high interest rates, high currency exchange fees, and politically motivated credit allocation (typically favoring SOEs at the expense of small business) creates another indirect trade barrier.[20]

After payment is arranged, the next requirement is fast, inexpensive delivery. For international customers, the mode of choice is likely to be air freight package delivery services; however, in most countries express package delivery has been greatly inhibited by regulations that seek to protect the postal system's parcel shipping service. Here an Egyptian direct mail retailer faces both internal and external indirect trade barriers, for even if Egypt were to open package delivery to unrestrained competition, barriers would remain in almost all nations. An important exception is the United States. If Egypt opened its domestic express mail system to such companies as Federal Express and UPS, the charges for shipping small packages to the United States plausibly could fall to levels that made direct marketing feasible in the United States. Unfortunately, in the much nearer and potentially more accessible European market, regulation has made express parcel delivery service prohibitively expensive. For example, shipping a seven pound package by air express from Paris to Frankfort, about 500 miles, is roughly four times as expensive as shipping the same package from San Francisco to New York, about 3000 miles.[21]

The last stage in successful international direct marketing is clearing customs. Even in the absence of formal trade barriers such as tariffs and quotas, cumbersome customs clearing that is subject to long delays, extensive bureaucratic forms, and frequent loss of parcels can make successful direct marketing unfeasible. These barriers can occur at both ends -- export checks as well as import clearances -- but the latter are likely

[20] For a discussion of these problems in Egyptian banking, see Mohieldin, op. cit

[21] Organization for Economic Cooperation and Development, "Parcel Delivery in the Global Marketplace," Committee on Consumer Policy, 1995, p. 12.

to be a much greater problem, where governments are likely to impose expensive process requirements to assure that imports are consistent with both formal trade rules and domestic product standards. Hence direct marketing from Egypt will require international negotiations with most trading partners for administrative reforms to facilitate rapid, inexpensive customs clearance.

Sales of consumer goods to retail outlets abroad involve most of the same issues. In the United States, the development of fast, reliable, inexpensive parcel delivery services has enabled retailers to reduce inventory/sales ratios by submitting smaller, more frequent orders. Hence to compete with other suppliers of consumer goods, Egyptian firms must be capable of "just in time" delivery to retail outlets, which raises the same issues about the quality and expense of communications, transportation, banking transactions, and customs clearance.

***International integrated manufacturing***

An important, growing component of international trade is vertical integration in manufacturing across international boundaries. Whereas this phenomenon is most prevalent among advanced industrialized economies (examples abound within Europe, between the United States and Japan, and between the United States and Canada), in many cases North-South integration has arisen. Prominent examples are the manufacture of automobile parts in Mexico for use in US automobile assembly and mass-produced memory chips in the emerging nations of Asia that are then incorporated into Japanese and American computers.

Internationalization of vertically related production can be inhibited by all of the same indirect barriers that were discussed in the case of sales to retailers or directly to customers. Crossing an international boundary usually requires transactions costs that are not faced by domestic producers. However, free trade areas, such as NAFTA and the European Union, avoid most if not all of these costs, indicating that international negotiation over these procedures can substantially reduce or even eliminate such barriers.

## 6. The Case for Internationalizing Regulatory Reform

As is apparent from the preceding discussion, trade agreements incorporating regulatory provisions can have many beneficial effects. One important result is that they allow nations to impose regulations that seem irrational to foreigners only if these regulations do not distort trade. Agreements of this form protect trade policy against regulations that are motivated by protectionism but are based on a well-articulated, if idiosyncratic or unscientific, rationale. They also run the risk of preventing a country from responding to scientific uncertainty by exercising caution, if the effect of such action significantly affects trade.

Given the organization of interest biases in regulatory policy, well-conceived idiosyncratic or unscientific regulations that enjoy widespread popular support are likely to be quite rare. The reason is that broadly based interests, with low per capita stakes but high aggregate value, are the very interests that are least likely to be protected by regulation. A nation that adopts an unusually stringent regulation with no hard technical foundation is most likely to be responding to special interest bias, not a popular political demand. For this reason, according higher legitimacy to trade agreements than to specific regulations has a reasonable theoretical foundation.

These same theoretical arguments provide another reason to believe that internationalizing regulatory reform is generally desirable. According to the economic theory of policy formation, a necessary condition for regulatory reform is that the reform process must avoid excessive responsiveness to organized special

interests in each regulated proceeding. This condition can be satisfied in two ways. One is for conflicts of interest among the regulated group to cause the group to lose its organizational effectiveness. For the most part, these conflicts arise mostly from accidents or unforeseen events, such as uncontrollable technological advances or major shifts in the composition or location of demand, such as when a new industry arises or a geographic area experiences substantial economic growth and immigration.

The other way in which the condition for reform can be satisfied is more in control of policy makers. This mechanism is to formulate regulatory policy as a broad, general reform issue. Thus, when trade policy migrated from sequential domestic consideration of product-specific tariffs and quotas to general negotiations of trade agreements, trade policy was elevated to a more general issue in which the perverse effects of biases in political organization were reduced. Likewise, incorporating regulatory reform into trade policy performs the same function for regulation.

In parallel fashion, incorporating regulatory reform into trade agreements can cause additional trade liberalization to enjoy greater domestic political support. In the example of port policy, in the first instance including relaxed entry controls in port services as part of a broader negotiation on market access in services elevates port reform to a more general economic issue in which the state port monopoly will have less influence. Then, once port efficiency is improved, other domestic industries, such as agriculture, that presently are not very internationally oriented due to the expense and delay of port transshipment will become supporters of further trade liberalization that gives them access to foreign markets. In this way international agreements that impose competition policy on SOEs facilitate both domestic regulation and further trade liberalization as well as increase trade in the industries directly affected by the agreement.

The key point is that internationalization can support broad liberalization if a large number of products and restrictions are on the table. Broad agendas undercut the advantages of entrenched interests that benefit from a particular protection, whether in trade policy or regulation. Thus internationalizing regulatory reform is much less likely to work if agreements are negotiated in a narrow, sector-specific context. Recent experience with narrowly focused international negotiations, whether in trade or regulation, bears out this expectation.[22] With the sole exception of the Agreement on Trade in Civil Aircraft, no single-issue negotiation under the GATT and few outside of it have produced significant results, and many have produced new, onerous regulations. Examples of failures are the International Dairy Agreement

[22] For more details, see Frieder Rossler, "Efficient and Inefficient Issue Linkages in Multilateral Negotiations: A Critical Examination of the 'Trade and ...' Trend," Center for Economic Policy Research, Stanford University, September 1996.

(establishing minimum world prices for dairy products), the Multi-Fibre Agreement (countenancing import quotas), and the Montreal Protocols (prohibiting reallocations among nations of both production and consumption of chlorofluorocarbons, thereby banning both the preservation of economies of scale as production shrinks and the increase in the proportion of these products that is traded). These outcomes illustrate that once the scope of international negotiation is severely restricted, special interests usually obtain protectionist provisions.

The preceding analysis leads to two parallel but analytically distinct conclusions. The first is that incorporating regulatory issues into international trade negotiations is inevitable simply because regulation has increasingly important trade distorting effects as direct trade barriers fall. The second implication, which is more controversial because it is less transparent, is that this trend is beneficial for both regulatory and trade policy -- as long as these issues are combined in the appropriate manner, through broad negotiations that elevate both trade restrictions and regulations to matters of general economic policy, rather than confine them to sector-specific industrial policy.

More open trade regimes assist regulatory reform in two ways. First, trade liberalization creates foreign pressure for reform to eliminate indirect trade barriers. Second, freer trade creates domestic pressures for regulatory reform because it increases the relative importance of inefficient regulation as a source of trade distortions that harm domestic industries. Likewise, domestic regulatory reform can increase domestic political support for further trade liberalization by giving domestic industries new opportunities for successful international sales. For this reason there are important economic and political complementarities between free trade and regulatory reform.

## PART II: DISCUSSION
## INTERNATIONALIZATION OF REGULATORY REFORM IN EGYPT

Participants in the discussion following Pr. Noll's presentation included Hassan El-Hayawan from Ain Shams University, James Kenworthy of the Development Economic Policy Reform Analysis project, Ayman Laz of ASKA Financial Consultants, Mona Omran El Shafei of the USAID Mission, Rene Milas of the European Union and Ahmed Galal of ECES. The following is a summary of the discussion.

**Chairperson:** Thank you for a very informative presentation. Before opening the floor for discussion let me recap the three basic points that I believe you have made: *first*, regulation can be very costly, especially at a time when the world is opening up; *second*, regulatory reform is actually a tough business and will not be easy; *third*, there are the many tensions you pointed out, which I will not repeat, that have to be taken into account as we go about the reform process. What I felt missing though was the Egyptian story. But with the combination of Egyptian audience and yourself, I am sure we will get to that. The floor is now open for discussion.

**Participant**: My question is related to the cost of regulatory policy and reform, and tensions that arise in the process. I have been trying to relate this to Egypt and have three questions in that regard. The first is whether you conducted a study on the Egyptian economy to measure the cost of regulation as a percentage of GDP? Second, what in your opinion, are the reform measures that should be taken for regulatory policies in Egypt? And third, what are your expectations regarding tensions that may arise out of these regulatory policies in the Egyptian economy?

**Speaker:** One of the big growth industries in economic research is estimating the costs and benefits of regulatory policies, in particular the costs and benefits of various forms of regulatory reform. The literature is so extensive that it defies brief characterization. Nonetheless I will try. Basically, privatization of public enterprise produces efficiency benefits. That is, substituting or adopting a regulated private monopoly instead of public enterprise typically reduces costs, and the numbers vary dramatically by country and by industry. In the United Kingdom the number has varied between five and ten percent cost reductions arising from the act of privatization. In some developing countries, such as Mexico, Chile, and a couple of others I can think of off-hand, the numbers can be much bigger. Typically, the numbers tend to be larger for developing countries. But I suspect that there is a

confounding of cause and effect here, and that part of it has to do with whether the privatization process allows foreign ownership. Usually the process does allow substantial foreign ownership in an industry that did not allow it in the past, which may explain the bigger numbers in developing countries.

My view is that the gains from pure privatization are relatively small compared to the gains from eliminating entry barriers. The threat of entry and the presence of some entrants is by far the most important factor in improving the efficiency of infrastructure. In the United Kingdom, for example, British Telecom still has 90 percent of the market, which is enormous. Its efficiency gains have been far greater than anybody ever expected when the process was begun. Eliminating entry barriers and allowing competition, even in businesses we think of as monopolies, like electricity, telecommunications and railroads, is a huge gain. It is even true in very small countries with relatively low per capita income that a very large fraction of these so-called national monopolies can be competitive.

With regard to Egypt in particular, I cannot tell you very much about the cost of regulation. All I can do is infer it from comparisons with other countries that have similar types of institutions and have undertaken liberalization reforms. The book that Ahmed Galal co-authored on welfare effects of privatization has detailed studies of Mexico, Chile, Argentina and a list of other countries, and can shed some light for Egypt.

Regarding specific actions for Egypt, basically the implications are: first, the trade off between sovereignty and political control versus efficiency, a trade-off that we have pretty well documented. The fact that the trade-off exists does not lead to a robust policy conclusion, but it would be outside the legitimate scope of this presentation to tell you what to do. What I can say is that in a country where telephone and electricity penetration is as low as it is in Egypt, there are potentially large efficiency gains to be obtained from eliminating entry restrictions. These gains have been demonstrated in a number of other developing countries.

**Participant**: I am interested in knowing how you see the factor of time in the process of domestic regulatory reform, as well as in international negotiations and settlements. For one thing, the legislation process itself can take time to initiate, review and amend, and its ultimate effect, whether harmful or beneficial, on the consumer needs to be considered. Then, there is the life-span of the politicians who are elected for a certain period of time, and have an agenda for being re-elected, which is in their own self interest. So there often seems to be a conflict of objectives in a given time-frame. These and other

things, such as dispute settlement procedures and enacting laws compatible with the WTO, take time, and for business time is money.

**Speaker:** One of my favorite cartoons is a picture of Albert Einstein at a blackboard with an enormously complex formula in front of him and he is filling the entire blackboard. It starts off: T=, followed by all this complicated algebra, and then at bottom it ends = $. The caption says: "Einstein discovers that time is money."

I think a fair statement on the domestic political process is that it may be committed to converting international liberalization to a hollow shell, and substituting discriminatory and inefficient regulatory policy for tariffs and quotas, as indirect trade barriers. There is really nothing we could do about it with organizations like the WTO. I think that the key to effective operation of international dispute resolution mechanisms is that they rest on the assumption that the parties to these negotiations generally want international liberalization. If they undertake domestic policy actions rejecting this purpose explicitly -- that the regulatory policy was enacted, in large measure, to be discriminatory and to trump this transitory liberalization -- then pointing it out or having a formal process that points it out will empower the liberalizing faction of each government to work out an accommodation.

I am always frustrated, as I think the questioner is, by the snail's pace at which liberalization reforms, whether domestic or international, take place. But on the other hand, sitting in 1997 and looking back to 1977, the amount of progress is enormous. A little bit of progress every year, year-in and year-out, over something far less than a person's life-time, produces remarkable progress. I share the view that if Germany really wants to keep *Cassis de Dijon* out of Germany, it can. If Denmark really wants to keep German beer out of Denmark, it can. But they are not going to sacrifice long-term liberalization over bottled beer or bottled liqueurs.

My second point is that the degree to which a country can be responsive to the potentiality, as well as the reality of disputes arising from regulation, is itself determined by the institutions of that country and the way it builds in responsiveness to the potentiality or reality of disputes. The United States is a good illustration. Congress saw the problem with having "Congress" write trade bills. The solution was to build-in responsiveness to liberalization that is fast-track with regard to trade negotiations. Congress therefore, passed a law stipulating that when the US trade representative is negotiating a trade deal, whether multinational or bilateral, if the Chairs of the House or Senate committees and the minority

leaders of the House and Senate committees that oversee trade legislation are made part of a negotiating team, Congress pledges to vote on the negotiated agreement (yea or nay), without amendment, within 90 days. In other words, a statute was passed that made it possible, in a very short period of time, to get a decision, on a trade liberalization law. Congress in effect said, if you give us a role in the negotiation process, given that we are in general committed to liberalization, we are going to tie our own hands to prevent us from getting in the way by slowing you down or by doing *de facto* one sided agreements through the addition of amendments.

Institutions differ from country to country and all of you know the situation in Egypt better than I. The key point, however, is that the degree to which a country is committed to liberalization is a crucial entering point. If you are not committed to it, it will not happen. The other point is the degree to which you can build-in responsiveness. That is a decision that needs to be made by each country given its political institutions and political realities. It is possible to: have slower or faster reaction time; to organize the way one considers, not only international policies, but policies with an international implication; and to build in ways that stack the deck in favor of the "economic growth" constituency. No country is going to get it perfect, in fact, no country gets even near perfect, but that is the necessary mind set. Each country needs to worry about constructing its own domestic political institutions for dealing with these issues in the broader context of its own political reality.

**Participant:** I think the bottom line, and the ultimate tension -- because I agree with your overall description of the dynamics -- is the tension between mutuality and sovereignty. As you know, sovereignty is an extremely sensitive issue in the developing world. What most people in the developing world may not realize however, is how extremely sensitive it is in the United States. In fact the United States very nearly did not approve the Uruguay Round Agreements after nine years of intensive negotiation over the issue of sovereignty. Your description of the outcome of the Venezuelan Oil case encapsulates the problem, which is that under the GATT/WTO Agreement, it is impossible for the WTO to veto the internal legislation of its member countries. That is a very sensitive issue.

In its new dispute-resolution process, the WTO settles trade disagreements between member countries. For example, if under the new process the WTO determines that the environmental protection law of one member country (the United States for example in the Venezuela vs. United States gasoline case) has cost another member country to suffer "nullification and impairment" of its trade rights under the GATT, it does not rule that the offending law must be changed, it simply imposes an economic cost

for application of it by levying a fine that requires the defending member to pay the claimant member an amount that will reasonably compensate it for the lost trade experienced due to the nullification and impairment of its trade rights.

This is important to the sovereignty issue because throughout the history of the Uruguay Round in particular, and multilateral trade negotiations in general, the developing world has had a sense that these multilateral negotiations constitute an effort by the developed world to capture, manipulate and dominate the economies of developing nations. Developing countries need to surrender that viewpoint and realize that there are economic benefits to involvement in a globalized economy. They need to accept global rules for doing business and recognize that there are economic benefits to be gained from working within the system and an economic cost for isolation. A WTO ruling against a developing country may force the country to make the choice of either continuing a policy because it makes political sense or absorbing the economic costs by making concessions to a complaining country or countries.

It is really just the use of terms that I am concerned about here because sovereignty is such a sensitive issue in the United States, as well as in the developing world.

**Speaker:** I do not want to engage in a debate about semantics, so I will use the word *de facto*. The fact of the matter and bottom line is that the United States does not have to do anything. The United States is big enough and powerful enough that had it really wanted to sacrifice relationships with Venezuela it could have done so. The WTO has no way of enforcing even the economic compensation component, but there is a sacrifice involved.

Sovereignty is an issue with every country in the world. France faced a sovereignty problem with the April 1st deregulation of European airlines. Air France is technically bankrupt and suffering strikes almost every day, and will suffer even more when it faces added competition with British Airways and Lufthansa. The issue is "Vive La France." It is sovereignty versus economic efficiency. And every country in the world has the same view of international dispute resolution and trade, feeling that the rest of the world is somehow imposing rules upon it. That is true in the United States, the United Kingdom and France, as well as every developing country. That feature of the debate is a political phenomenon of the first order literally everywhere.

**Participant:** Going back to the issue of the high cost of regulation for a country like Egypt, I have two questions. We can all agree that there is excessive regulation almost everywhere, but as a policy-maker, where would you start and what channels would you use? My second question concerns a related issue

that is important for policy-makers facing a long list of excessive regulations has to do with "wrong" and "right" regulations, or which you want to regulate and deregulate? This particular issue touches on everything from health, environment and safety regulations, to monopolies and required documentation -- even for going to the airport and trying to export. It is all over the map. Give us an idea of where you think the gains would be greatest in Egypt and how to begin.

**Speaker:** Both questions are basically asking, "Where to look?" The classic answer is *look at the existing set of regulatory policies that are causing the most domestic inefficiencies, that are inhibiting investment, inhibiting technological progress, inhibiting cost reductions and do it purely on the basis of cost benefit analysis.* Setting exact priorities requires a great deal of work. However, I think the only important lesson here is that it is a horrendous mistake to believe that the degree to which the Egyptian economy is internationalized today is a good predictor of how it might be twenty years from now under a more liberalized regime. All nations should base their liberalization decisions on a realistic plan of where their economy should be in twenty years, and ask what regulatory barriers stand in the way: barriers that may appear purely domestic, but distort international rules? What is it that Egypt would like Europe to do to facilitate doing business in Europe twenty years from now, that makes it impossible now? Question exactly what is it that Egypt wants Europe to do to liberalize, and what is Egypt willing to give up to get it? In my opinion, that is the right way to think about it. Again, domestic consequences are crucial in the short run, but if there is a decision to liberalize and to take advantage of world trade as an instrument of global economic growth, then long-term planning is needed to determine what Egypt can do that it is not doing now to be more effective in trade with international trading partners. Next, see where domestic rules get in the way.

It seems to me that the key point is one made earlier, which is as one eliminates formal trade barriers, the cost of regulatory distortion increases. Obviously, improvements in GDP should be taken from wherever they can be found, whether domestic or international. The fundamental rational for getting rid of ineffective, inefficient regulations exists regardless of its international impact. As in the United States, one should not view the rising international pressure to engage in domestic liberalization as a sort of purely political exercise of muscle-power, but because over-regulation has a distorting effect. It is just another aspect of the same fundamental problem that already existed inside the country.

**Participant:** Deregulation, in the context of negotiating international agreements as a binding force or an anchor of reform is one option. But a country also has the option of doing it because it is the right thing to do. I wonder if you would share your thoughts on these two approaches?

**Speaker:** This question relates to the nature of the goal, and how one sets priorities. Remember the example I used to focus on performance. The United States, essentially to comply with its agreement under GATT, had to sacrifice an environmental policy goal in order to honor WTO decision. It did not need to do that. A perfectly reasonable way to go about regulating gasoline would have been to simply set a standard for gasoline -- from any source, origin or producer. However, the United States was not willing to stop there, because it allowed distributive politics (different sets of rules for domestic and international refiners) to pollute, if you will, the environmental policy objective.

So we see that the dispute arose, not because the United States has stringent air pollution control regulations. It arose because the United States tried to implement its policy in a distorted way. The lesson here is that a nation does not have to sacrifice its social policy objec tives in order to have a transparent and open, non-discriminatory social policy. A nation does not have to adopt another nation's values in order to have international liberalization. But, what it does have to do is make explicit what the objectives are, and treat everyone equally in pursuit of those objectives.

**Participant:** I would like to hear your views on the extent to which regulation, in the "bright new world," would be moving off-shore and into the international arena rather than the domestic are na. For example, the European Union was conceived as an organization to promote trade within Europe as a common market. However, many people would complain now that while that has certainly happened, and the amount of internal trade has greatly increased, the EU has also become a major regulatory agency in itself because of the necessity to develop common standards in a wide range of areas. Does that mean that -- as we move down the liberalization approach, moving from the microcosm, if you like, of the EE unit to the broader international arena -- we are going to see the WTO having to establish common standards in a whole range of areas? Or, are we going to see maybe a hegemony of the major trading partners who will impose their own standards in effect on their trading partners by virtue of their muscle?

A specific example here relates a recent announcement that Egypt will ease its established import standards and accept the standards of certain major trading partners. Similarly in its export trade with Europe, Egypt accepts the standards established and imposed by the Europeans.

**Speaker:** That is an extraordinarily deep subject, as you know. There is no question in my mind that some areas of regulation will become internationalized, either through the establishment of entities like WTO international regulatory institutions, and courts to enforce them, or through multilateral negotiations and treaties. The truth of that is demonstrated in any circumstance in which national boundaries are essentially used as an arbitrary means to demarcate markets or the consequences of actions.

Obviously, if there is going to be effective control of $CO_2$ global warming it has to be of an international character. No single country can have a monopoly on global warming, no matter what it does. Likewise, regional water and air pollution problems typically transcend national boundaries. For example, the way to stop acid rain in Germany is to put controls on power plants in England. The way to stop acid rain in Maine is to put controls on Canada. Likewise, the way to stop it in southern Ontario is to put controls on power plants in the mid-west of the United States. The bottom line is that a lot of things are international.

Telecommunications is also a wonderful example in that the nature of the technology is such that it no longer makes sense to think of national networks. Even in a country as large as the United States, it makes no sense to think of "the United States telecommunications system." Thirteen percent of sign-ons to the Internet by Americans are to websites in other countries. Given that, either these regulatory policies are going to be hereditarily inefficient because one nation will not take into account the implications of what it is doing to another, or regulation will need to be internationalized.

However, there are a lot of other areas, where it does make sense to think of countries as markets. In those cases there are efficiency advantages to harmonization to adopting common objectives. But there, it seems to me that we might be able to argue -- as in the case of Canadian red raspberries, or bottled recycling rules in Denmark and Germany -- that these requirements have nothing to do with the stated regulatory purpose. They are just indirect trade barriers that need to be nullified.

On the other hand, if a country wants a standard of safety, healthfulness, or performance that is greater than another country, it strikes me that we have no legitimate bases to prevent that. Or, countries

can insist that people have common standards for the purpose of capturing scale economies of production. There are some efficiency advantages to having common standards. Some countries *de facto* have approximately the same objectives. If you look across the European Union, the United States, Japan and Canada, and examine what the performance requirements of most of their environmental health and safety standards are, you see that they are basically the same. It is just that they implement them differently and create trade barriers because they try to achieve the same objective with different means.

A general insight, therefore, appears to be that some of actions are clearly for the purpose of distortion while others are perfectly legitimate. It seems to me that if the United States wants to have tougher standards for drinking water than France, then it should be allowed to do so, it is willing to pay the cost. I think what we have learned that a very high fraction in the differences of these regulatory rules is not for the purposes of differences of performance, but simply distortions.

**Participant**: I am trying to imagine your entire presentation condensed into two matrixes: one with *trade barriers and international trade* showing the variables; and the second with *domestic regulations and international trade* showing those variables. The matrix might make it a little easier to understand or measure how both scenarios would impact on international trade.

The basic assumption is that globalization will, and should, be good for economic efficiency. I think that for developing countries it is a little difficult to jump very quickly into globalization. I rather prefer the idea of regionalization first. It is hard to imagine that the speed of deregulation, or the domestic deregulation process in developing countries could be implemented at the same pace.

In the case of Egypt, it might be more effective and secure to think in terms of regional rather than global first and move forward from there because we have a lot of protection within this region. What if we start considering all of the variables that you mentioned regarding domestic deregulations effecting regional trade and then gradually enter globalization by adjusting our domestic policies towards the globalization process? How can we manage the process prudently and consider all consequences, because if we open the window very quickly we might catch cold? The question really is one of whether to go regionally or multinationally, and which can we afford.

A related question regards the evolution of technology vis-a-vis the regulation and pricing policy. A good example is what happened in the United States, notably in the communications sector, where regulation favored consumers at the expense of the private sector, especially intermediate or medium-size businesses and their employees, many of whom lost jobs. Are medium-size businesses and mid-level

employees exposed to unfair competition, or suffer disadvantage due to advances in technology and the over speedy implementation of regulatory policy reform that favors the consumer?

**Speaker:** These are really the same question. Both questions imply that if globalization and liberalization are speedier, they are likely to be more disruptive. So, the idea of starting off regionally with countries that are like you in economic structure, culture and everything else, is essentially a proposal to move slowly and minimize disruption. And, I should think this approach would be especially attractive to Egypt which is so big relative to its neighbors. In a regional free-trade zone, Egypt would have the same status that the United States has with NAFTA, as the dominant player.

Let me start by answering the second question, then go to the first. You are absolutely right that policy in the United States, for a host of reasons that would not be productive to go into here, is much more oriented towards consumers than anywhere else in the world. Individualism, whether expressed politically or economically, has enormous political clout in the United States. Deregulation in transportation bankrupted twenty-five percent of the firms involved in the industry and caused the people who worked for those firms to lose their jobs, and the people who invested in the firms to lose their assets. The flip side of course is that *total* employment and *total* investment in those industries skyrocketed. Also, there are many more pilots flying now for American airline companies than there were before deregulation; they are just flying for different companies. So the disruption was a transition disruption, and really most of the cost of deregulation took the form of wages for pilots or truck drivers that were on the order of fifteen percent lower in real terms.

But, of all the losses suffered by investors who went out of business, the biggest was by stockholders of Eastern Airlines, Pan American, and Braniff, or others that went bankrupt. I do not think any country in the world, as far as I can tell, has a set of values and political institutions that would allow that to happen. So I am happy and at ease with go-slow policies that would not allow that kind of thing to happen. I think it is important to bear in mind however, that in the airline industry for every job that was lost there were two new jobs created. That is a relevant fact to bear in mind.

It seems to me again, that it depends on where you are. Every country in the world has regional and global arrangements. Almost every one is a member of GATT. Each has a different timetable for what it is going to do, but almost every one has bilateral agreements with nearby trading neighbors. Every country to some extent is regional and each is to some extent international. It is true that on the one hand

the efficiency gains are greater if the scope of the trading agreement is broader. It is also true that if a country liberalizes more rapidly with countries having a similar economic structure, the disruptions will be less because of the very same reason. However, if five adjacent countries all have a very inefficient sector create a regional trading organization, all five will continue to be equally disadvantaged in that sector. No one country is going to experience some massive loss, because all of them do not do it very well. So it is a straight trade-off. How much disruption are you willing to put up with? If you are willing to put up with very little then establish liberalization relationships with countries that are as inefficient as you. The United States can do that. It can say, "We are going to be really open with respect to Mexico, because it does not threaten us with anything much, but Venezuela has a really efficient oil industry, and we have to worry about that, so let's mess around with their gasoline." That is a classic story and it happens almost everywhere. It is part of the trade-off. Not wanting to destabilize your own country politically by causing massive disruption is a perfectly legitimate and valid goal. The relevant policy issue is to assess the relative importance of promoting economic growth versus avoiding economic change and disruption. If internal disruption has infinite cost, then obviously, no amount of efficiency gained from reform is worth it. Anyone would be a fool to tell you to sacrifice infinite value for a finite efficiency gain.

**Chairperson:** I was almost getting worried when you said you are happy that countries can do whatever, no matter how much it costs. I guess I felt more comfortable at the end when you mentioned that there are trade-offs, and there are costs of disruption that are manageable and costs that are not. But on that note thank you very much indeed, and thank you all for coming.

## APPENDIX
## LIST OF ATTENDEES

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Ross Edgar Bigelow
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*Principal, Booz-Allen & Hamilton Inc.*

Mohamed Lotfy Mansour
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*Attache Juridique, Embassy of France*

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